CAC Specialty™

August 16, 2023

The Department of the Interior, Bureau of Ocean Energy Management, Office of Regulations
Attn: Kelley Spence
45600 Woodland Road
Mailstop VAM-BOEM DIR
Sterling, VA 20166

RE: Risk Management and Financial Assurance for OCS Lease and Grant Obligations, RIN 1010-AE14

To Whom It May Concern,

With this memorandum, CAC Specialty is utilizing the opportunity to provide comments to and to request feedback and guidance on the Proposed Rules for Risk Management and Financial Assurance for OCS Lease and Grant Obligations, RIN 1010–AE14.

As a surety bond brokerage firm for many lessees in the Gulf of Mexico, we feel it is our duty to express our concern with some of the provisions set forth in the Proposed Rules for Risk Management and Financial Assurance for OCS Lease and Grant Obligations, RIN 1010–AE14 (the "Proposed Rules"), while also seeking further clarity from the BOEM. Additionally, as experts in the OCS surety bond space and as members of the National Association of Surety Bond Producers ("NASBP"), we wish to express our qualified opinion on some concerning matters in the Proposed Rules. The commentary presented is solely that of CAC Specialty and should not be treated as the formal opinion of any one of our clients or NASBP.

Comments to the Proposed Rules

1. We agree that more definite regulations need to be established as the industry has been in regulatory limbo for nearly a decade. While the Proposed Rules provide a better-defined window of who may need to provide new or additional financial assurance, several key items that would seem obvious to those in the surety market for the BOEM to address were left out of the Proposed Rules. We will address these in further detail later, but they include:
    - Order of alignment
    - Surety subrogation rights
    - Certain disclosures around the $9.2 billion financial assurance increase
    - US taxpayer losses incurred to date
    - The rules interaction with existing joint operating agreements ("JOAs").
2. At times, the focus of the Proposed Rules shifts from protection of taxpayers to protection of predecessors in title. Specifically, this shift is evident where the BOEM states, "allowing current lessees not to provide supplemental financial assurance based on a predecessor lessee's strength may incentivize current lessees to not consider decommissioning costs in their business decisions… This ''moral hazard'' could distort the market for lease transfers by allowing a buyer and seller to conduct a transaction without calculating in end-of-life decommissioning cash outflows …."[1]
    - This approach implies that sellers in a transaction are unaware of the chain of title liability associated with any transaction on the OCS. Since the ATP Oil & Gas Corporation bankruptcy in 2012, sellers have been very keen to require non-government or private plugging & abandonment ("P&A") bonds or other financial assurance remedies (indemnities, etc.) from non-qualified buyers. The BOEM

[1] **Federal Register** / Vol. 88, No. 124 / Thursday, June 29, 2023 / Proposed Rules / Page 42159-42160

should focus on requiring supplemental financial assurance on leases wherein neither the current nor predecessor lessees (to the extent they are in the pertinent liability chain) are investment-grade.
    - A counterpoint to this "moral hazard" argument is that an operator's prior compliance with BOEM and BSEE regulations should be a significant indicator as to whether an operator would or would not rely on the "majors' backstop". Said another way, perhaps allow the inclusion of pertinent predecessor lessees only if the current lessee(s) have a good compliance record (i.e., if a current lessee has a good compliance record, that may indicate the lessee would not haphazardly ignore late-life decommissioning cash outflows when making business decisions).
    - The "moral hazard" exists under the Proposed Rules as currently drafted, in that an operator may be incentivized to ignore decommissioning costs in their business decisions as they are required to have a surety bond to cover decommissioning costs (i.e., the operator would not focus on the decommissioning work because the operator knows it can still pass the loss on to the surety). This idea is further supported by federal case law which does not bode well for the surety markets.[2]

3. Similarly, the approach used to address the other two concerning lessees (Stone Energy Corporation and Energy XXI, Ltd.)[3] was a tailored plan that had a heightened focus on sole liability leases (i.e., no co-lessees and no predecessors).
    - One idea similar to sole liability would be that supplemental financial assurance should not be required for properties with at least one current or former owner that carries an investment grade credit rating. Or possibly that the BOEM should consider the creditworthiness of all current and former owners in the pertinent title chain.
4. Surety is cited as the primary source vehicle for the expected $9.2 billion increase to financial assurance, however, the surety industry is not obligated to commit funds in further coverage to this cause, whereas the pertinent predecessors in title are indefinitely saddled with the burden of decommissioning liability. While we understand the BOEM's concerns regarding taxpayer protection, the bankruptcies cited in the Proposed Rules have been extremely detrimental to the surety market.
    - This massive bond increase the BOEM seeks comes on the heels of some of the largest OCS related surety losses in history. Markets have withdrawn, capacity is low, reinsurance expenses and losses have driven up rates, and the carriers have some very negative case law concerning their product.
    - OCS decommissioning surety has lost the support of several major European-based insurance companies, and a few select US markets who not only experienced significant recent losses but experienced firsthand the negative outcomes and ruling of the federal bankruptcy court. Only about a dozen carriers remain, which means that, if distributed evenly, each carrier would take on an average of $750 million in new bonds, a potentially futile exercise.
5. Like a Greek Tragedy, the BOEM's actions could expedite the outcomes it wished to avoid. The regulations BOEM wishes to implement could expedite financial defaults of inadequate lessees prior to them obtaining financial assurance.
    - A similar incident was contemplated recently when the State of Colorado changed their P&A financial assurance requirements. Their experience may be important for the BOEM to analyze.

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[2] Summary Article: https://bracewell.com/insights/subrogation-shutdown-texas-southern-district-court-upholds-exercise-bankruptcy-code

[3] **Federal Register** / Vol. 88, No. 124 / Thursday, June 29, 2023 / Proposed Rules / Page 42139

Questions

1. The surety industry is looking for a direct and clear answer around order of alignment, as such, who would be first to pay in a default scenario?
    - *Example: A lessee has filed for bankruptcy and will not have continuing operations at a lease that possesses decommissioning liability. That lease has a supplemental bond (not a private P&A bond) and several pertinent predecessors. Will the BOEM look to the predecessors first to cover the liability prior to filing a claim under the supplemental bond? This order of alignment should be clearly and concisely delineated in the final rule.*
    - *Surety underwriting is a methodical process. Without a clear understanding of the default triggers, it becomes difficult for markets to participate, especially when seeking such a sizable figure for the industry.*
2. The BOEM performed a significant amount of research on this subject matter and was able to estimate that these rules would net an increase of $9.2 billion in additional financial assurance. Within this vein we ask the following:
    - *Does this purported increase account for existing financial assurance that would be lost to assets that meet the 3:1 proved value to* decommissioning *cost estimate exemption?*
    - *Of the $9.2 billion, what are the allocations per lessee? Per Operator?*
    - *To obtain probabilistic feedback on the market's ability to obtain such a sum, this lessee information would be incredibly helpful.*
3. If a lessee already has financial assurance and simply needs to provide an increase to that financial assurance, for the three-year phase-in period, would this apply to the increase or the lessee's portfolio as a whole?
    - *Example: Lessee has $10 million in existing financial assurance but under the Proposed Rules, has a total P70 liability of $13 million. Would the lessee be allowed to phase in $1 million a year over the three year period OR, since the lessee already has over 2/3rd coverage, could it post the remaining $3 million in year three of the phase-in period?*
4. What are the Taxpayer losses incurred to date under the existing rules?
    - *What losses has the taxpayer incurred on the combined 30 bankruptcies since 2009?*[4]
5. Does an investment grade credit rating of a company automatically apply to the company's wholly owned subsidiaries, or will that be considered a 3rd party guarantor?
6. The general practice under a JOA is that the financial assurance is the duty/responsibility of the operator.
    - *Recognizing that the owners in a well have joint and several liability, but, as noted above, for convenience the operator has taken on BOEM financial assurance, are the Proposed Rules to override such allocation of responsibility, or will they only apply to new obligations arising under new JOAs?*
7. When looking at the named parties on a lease and serial register page, does the BOEM only look at record title holders or can this be further broken down to look at specific aliquots, knowing that those are distinctly defined and often entirely separate operations from the rest of the lease?
8. With regards to the value of the reserves serving as an exemption to financial assurance:
    - *How will the BOEM evaluate reserves from conflicting reports around proved value when multiple co-lessees are involved?*

[4] **Federal Register** / Vol. 88, No. 124 / Thursday, June 29, 2023 / Proposed Rules / Page 42139

- *What consideration is being given to the midstream companies in the OCS space? If their asset is tied to a qualifying 3:1 lease, should the same rights be given to the owner of that right-of-way since their values are inherently tied to one another?*
- *Additionally, would the BOEM consider useful life as a qualifying metric in addition to proved value, as a long useful life provides the same assurance that another lessee would assume ownership in a liquidation event? What would the BOEM view as an adequate threshold here?*

9. If a predecessor in title cannot escape their decommissioning liability, why not then make that predecessor's obligation a part of the value of the lease with respect to existing liability and have a separate rule dealing with decommissioning liability from a go-forward date?

10. Obtaining surety bonds for an OCS lease is already an adverse selection exercise. Now with the best properties no longer requiring bonds (by not requiring supplemental financial assurance on leases with PV-10 that are 3X the P70 decommissioning liability), the BOEM is asking sureties to bond the riskiest assets on the lower financial quality lessees.

- *With the lessons learned in the Fieldwood Energy LLC bankruptcy around the denial of a surety's subrogation rights post-bankruptcy and a 363 sale, what assurance/protections does the BOEM plan to offer the surety market in exchange for providing future coverage? Again, there is federal case law supporting "moral hazard" for the sureties here.*[5]
- *How can a surety ensure that the revenues of the assets that once qualified their underwriting decision are going to remain with their lesser value bonded assets?*
  - *The same way the BOEM identifies the "moral hazards" of waiving supplemental financial assurance simply because there are predecessor lessees, sureties view the Fieldwood ruling and the 363 sale as a negative possible outcome now for every bonded client.*

In summary, we believe the surety market will be able to respond to some of these needs. Most lessees have strong relationships with their surety partners. There is also the opportunity for carriers to hone their business model and adapt to deliver for the industry and taxpayers. However, the Proposed Rules, as currently drafted, leave certain issues unanswered and, until those issues are addressed, the Proposed Rules are unworkable.

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[5] Surety Claims Institute Newsletter – Sept. 2021: https://media.clarkhill.com/wp-content/uploads/2021/03/15103947/THE-FIELDWOOD-ENERGY-SAGA.pdf